Kinloch Resources Inc.

2003 Annual Report

Corporate Profile

Kinloch Resources Inc. is a Calgary based natural gas exploration, development, and production company. Kinloch's active areas are primarily operated, high working interest and focused in Southern and Central Alberta. The corporate objective is share value appreciation through growth in cash flow, net income and asset value.

Common shares of Kinloch Resources Inc. trade on the Toronto Stock Exchange under the symbol "KTE".

Annual General Meeting

The Annual General Meeting of the shareholders of Kinloch Resources Inc. will be held at 3:30 p.m. on Tuesday, June 15, 2004 in the Cardium Room at the Calgary Petroleum Club located at 319 – 5th Avenue SW, Calgary, Alberta.

Abbreviations

ARTC	Alberta Royalty Tax Credit	GJ	gigajoule
bbls	barrels of oil and/or natural gas liquids	M	thousands
bbls/d	barrels of oil per day	mm	millions
bcf	billion cubic feet	mcf	thousand cubic feet
boe	barrel of oil equivalent (6 mcf is equivalent to 1 bbl)	mcf/d	thousand cubic feet per day
boe/d	barrel of oil equivalent per day	NGLs	natural gas liquids
btu	british thermal units	WTI	West Texas Intermediate benchmark crude oil

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Message to Shareholders

Kinloch achieved a number of goals in 2003 including:

- established a base of cash flow and production to facilitate future growth
- assembled staff with track records for creating value
- commenced exploration strategy
- increased stock trading liquidity

Nu-Sky Energy Inc. was acquired on July 31, 2003 for approximately $13.2 million in cash and approximately 9.1 million common shares of Kinloch. This transaction established a base of cash flow and production to enable the Company to set up infrastructure and hire staff, which is expected to accelerate growth and ultimately increase share value.

As partial funding for the acquisition, a private placement was closed September 30, 2003 consisting of 6,500,000 common shares at a price of $1.55 per share and 500,000 flow through common shares at a price of $2.00 per share for gross proceeds of $11,075,000.

The absorption of Nu-Sky proved to be challenging from a number of perspectives. Pre-acquisition production volumes were overstated due to errors in Nu-Sky's reporting systems, significant expenditures were required to repair equipment to meet industry safety and operating standards, environmental problems were dealt with and accounting errors were corrected.

The following individuals joined the team in 2003 and early 2004:

Randy L. Bergmann, P. Land, Manager, Land
Stephen C. Farner, B.Sc (Geology and Geophysics), Vice President Exploration
Tamara R. Herperger, B. Comm., Operations Assistant
Fotina A. Karavas, MSc, Senior Geologist
Diana Nicolson, Office Manager
Ron A. Parisien, B. Comm., Controller
Warren R. Pearson, B.Sc., Senior Geophysicist
Glenn D. Schiffner, C.E.T., Production Superintendent
Keith E. Macdonald, C.A., Director

Kinloch is set up and staffed as an exploration Company. In an environment where premium prices are being paid for the acquisition of oil and gas assets and companies, there is still an opportunity to add value through exploration. Mr. Farner was a Senior Geophysical Advisor with a major international exploration and production company and, together with his exploration team, brings considerable technical expertise, particularly in advanced applications of 3-D seismic. The focus areas for the Company for 2004 and beyond are in southern and central Alberta for targets where seismic has shown to be an effective exploration tool.

Although Kinloch's production volumes are lower than expected at this time due to more time required to drill and bring wells on production with record high levels of industry activity, early breakup and delayed plant expansion, the growth plan for the Company is intact.

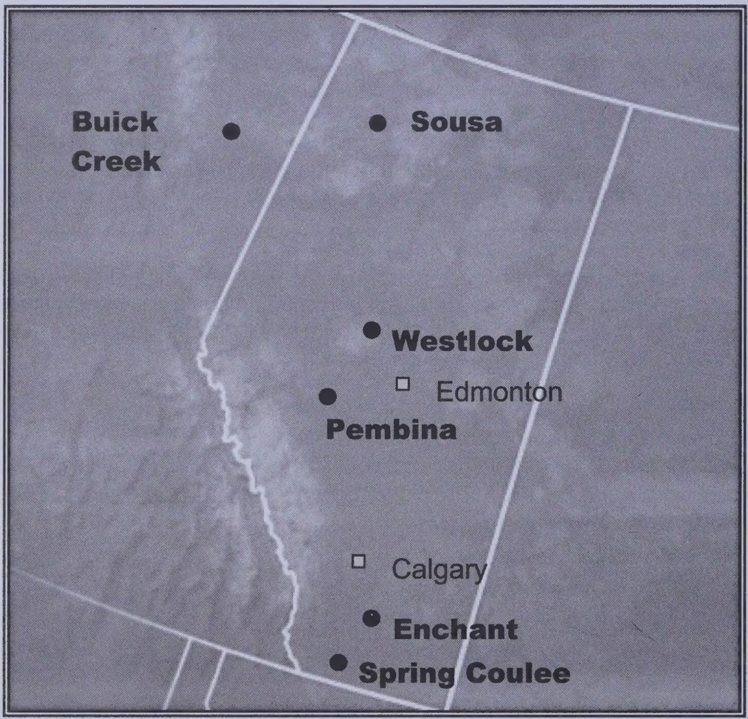
In the Enchant area, 22 sections, at an average 80% working interest, have been assembled and are covered with 3-D seismic. Four locations have been surveyed and are ready to be drilled after breakup. Additional wells are being planned on these lands for later in the year.

At Westlock, three 100% working interest sections were acquired and seismic was shot which have defined two drilling locations. These have been licensed and are expected to be drilled this spring.

Three cardium oil wells were recently completed at Pembina and six infill locations remain to be drilled.

A potentially high impact play has been developed at Spring Coulee, in Southern Alberta, with two 100% working interest sections and seismic acquired.

Locations have been surveyed at Sousa in northern Alberta (50% working interest) and at Buick Creek in British Columbia for Cecil formation production (30% working interest). In addition, an anomaly has been identified in the Slave Point formation at Buick Creek on 3-D seismic. Because Sousa and Buick Creek are outside of Kinloch's focus areas, these plays will probably be farmed out, leaving the Company a carried residual interest.



In March, an agreement was reached whereby Kinloch has access to approximately 500 square kilometers of high quality 3-D seismic data in Central Alberta where Kinloch is concentrating its exploration efforts. The terms of the agreement include the payment of a gross over-riding royalty on wells drilled and a best efforts drilling commitment over three years. Kinloch expects to generate numerous drilling opportunities from the seismic database.

To increase stock trading liquidity and expand the company's investor base, Kinloch commenced trading on the Toronto Stock Exchange on August 8, 2004.

In summary, a number of important goals were achieved in 2004 and Kinloch is now poised to start increasing production with internally generated prospects. A base of production and cash flow has been established, a strong technical team has been assembled and execution of the exploration strategy has commenced.

I thank the staff and directors for their hard work over the past year, and shareholders for their confidence in the Kinloch team.

Paul W. M. Read, P. Eng
Chairman, President, and C.E.O.
May 13, 2004
Calgary, Alberta

Management's Discussion & Analysis

Management's discussion and analysis (MD&A) should be read in conjunction with the audited financial statements for the years ended December 31, 2003 and 2002. Petroleum and natural gas reserves and volumes are converted to a common unit of measure, being a barrel of oil equivalent (boe), on a basis of six thousand cubic feet (mcf) of gas to one barrel (bbl) of oil. This discussion contains forward-looking statements that are not historical in nature and involve risks and uncertainties. Forward-looking statements are not guarantees as to the Company's future results since there are inherent difficulties in predicting future results. Accordingly, actual results could differ materially from those expressed or implied in the forward-looking statements. Readers are encouraged to review Kinloch's Annual Information Form and other public documents at its website at www.kinlochresources.com or at www.sedar.com.

On July 31, 2003, Kinloch Resources Inc. ("Kinloch" or the "Company") acquired all of the issued and outstanding shares of Nu-Sky Energy Inc. ("Nu-Sky"). Nu-Sky was wound up into Kinloch immediately after the acquisition. Accordingly the results of operations include the Nu-sky operations for the 5 months from August 1, 2003 to December 31, 2003. Kinloch has grown approximately 10 times as a result of the acquisition, thus comparative analysis of Kinloch's results for the prior year are of limited value, although disclosed, and therefore the MD&A will focus mostly on this year's results.

Financial Highlights

$000's (except per share amounts)	2003	2002
Production revenue	5,678	130
Cash flow from operations (1)	2,388	(102)
Per share		
- basic	0.19	(0.03)
- diluted	0.19	(0.03)
Net earnings (loss)	(741)	389
Per share		
- basic	(0.06)	0.11
-diluted	(0.06)	0.10
Working capital (deficiency)	(6,324)	3,135
Total assets	40,192	6,050
Shareholders' equity	23,542	5,069
Number of common shares outstanding at December 31		
-basic	25,502	5,417
-diluted	27,027	6,174
Weighted average common shares outstanding		
- basic	12,714	3,583
- diluted	12,798	3,793

(1) Cash flow from operations is a non-GAAP term that represents net earnings adjusted for non-cash items including depletion, depreciation and amortization, site restoration, future income taxes, asset write-downs and gains (losses) on sale of assets, if any. Cash flow per share is calculated by dividing cash flow from operations as previously described by the weighted average number of common shares outstanding during the period

Operating Highlights

		2003	2002
Oil and liquids production	(bbl/d)	62	3
Natural gas production	(mcf/d)	2,000	10
Total oil equivalent	(boe/d)	395	13
Product prices			
Oil and liquids	($/bbl)	38.31	38.12
Natural gas	($mcf)	6.58	4.07
Weighted average	($/boe)	39.28	27.92
Operating costs	($/boe)	10.42	8.23
Netback (after royalties)	($/boe)	21.96	16.18

2003 and 2002 Quarterly Summary

	2003				2002			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Production (boe/d)	800	631	76	62	10	24	10	10
($000, except per share amounts)								
Revenue, net of royalties	2,251	1,999	218	277	46	69	36	36
Operating expenses	957	471	35	39	12	14	5	6
General administrative	180	206	113	77	33	49	75	32
Interest	49	145	19	14	47	-	-	15
DD&A & site restoration	2,228	1,171	108	73	10	13	13	14
Income taxes	(200)	36	(45)	(190)	(540)	-	-	-
Net earnings (loss)	(963)	(30)	(12)	264	484	(7)	(57)	(31)
per share:								
– **basic**	(0.11)	0.00	0.00	0.05	0.14	0.00	(0.02)	(0.01)
– **diluted**	(0.11)	0.00	0.00	0.05	0.13	0.00	(0.02)	(0.01)
Cash flow:	1,061	1,128	51	146	(46)	6	(45)	(17)
per share:								
- **basic**	0.07	0.08	0.01	0.03	(0.01)	0.00	(0.02)	0.00
- **diluted**	0.07	0.08	0.01	0.03	(0.01)	0.00	(0.02)	0.00

Production Revenue

($000's)	2003	2002
Natural gas	4,801	85
Liquids & oil	862	42
Processing	15	3
Total	5,678	130

Production Volume

Natural gas (mcf/d)	2,000	10
Liquids & oil (bbl/d)	62	3
Total (boe/d)	395	13

Average Selling Price

Natural gas ($/mcf)	6.58	4.07
Liquids & oil ($/bbl)	38.31	38.12
Total ($/boe)	39.28	27.92

Kinloch's production averaged approximately 75 boe/d for the first seven months of 2003 prior to the Nu-Sky acquisition and increased to 624 boe/d in the third quarter, reflecting two months of Nu-Sky production. Average daily production for the fourth quarter was 800 boe/d, consisting of 4092 mcf/d of gas and 118 boe/d of oil and natural gas liquids.

Natural gas prices averaged $6.58/mcf for 2003, representing a slight deterioration of the September 30 year to date average of $6.89/mcf. Two gas hedges were in place for the period from August 1 to October 3, 2003 consisting of 1000 GJ/day at a fixed price of $6.29/GJ and 2500 GJ/day at a fixed price of $7.19/GJ. These two contracts added an additional $519,000 to Kinloch's revenue during this period over what the Company would have received on the spot market. A minor contract for 50 bbl/day of oil expired at September 30, 2003 with no significant gain or loss realized during the term when it was in place. Kinloch had a costless collar in place from October 1, 2003 to March 31, 2004 at a collar range of $6.00 – $9.85 for 2000 GJ/day of gas with no significant gain or loss incurred up to December 31, 2003.

Other revenue of $78,000 consists mostly of interest income earned on cash balances and money market instruments prior to the Nu-Sky acquisition with a comparative amount of $77,000 for 2003.

Royalties

($000's)	2003	2002
Crown	793	16
Freehold & other	365	6
ARTC	(148)	(3)
Total	1,010	19
Royalty Rates: (as percent of revenue)		
Crown	14.0	12.3
Freehold & other	6.4	4.6
ARTC	(2.6)	(2.3)
Total	17.8	14.6

Kinloch's royalty rates as a percentage of income in 2003 are somewhat lower than industry average due to the hedging gain of $519,000. which is included in production revenue but not subject to royalties. The Company expects royalty rates to rise accordingly in 2004 subject to the outcome of the future hedges, if any.

Operating Expenses

	2003	2002
$000	1,502	38
$/boe	10.42	8.23

Operating costs rose sharply in the fourth quarter of 2003 to $13.00/boe compared to a year to date September 30, 2003 cost of $7.73/boe. After acquiring the Nu-Sky assets several initiatives were undertaken to bring the operation up to industry standards, including repairing and upgrading equipment, installing more efficient equipment and addressing safety and environment concerns. In the Pembina area, approximately $240,000 was spent on non-routine maintenance as the tubing failed on several wells requiring new strings to be installed, bottom hole pumps needed to be replaced due to excessive wear and lack of maintenance on surface equipment required repairs and maintenance. Significant expenditures were also incurred at the Company's Scandia and Sousa areas, which, along with future benefits from the Pembina expenditures, should result in a reduction in ongoing operating costs.

General and Administrative Expenses

($000's)	2003	2002
Gross G&A	940	205
Capitalized G&A	(112)	-
Overhead Recoveries	(252)	-
Net G&A	576	205
($boe)	3.99	44.87

Gross G & A more than quadrupled over 2002 amounts as Kinloch began hiring full time employees in the fourth quarter of 2002 and continued this process throughout 2003, particularly in the last half of 2003 when the Nu-Sky acquisition was solidified. At year-end 2003 the Company had satisfied most of its staffing requirements and accordingly a leveling off of gross G & A is expected in early 2004, although on a year over year basis, 2004 will reflect higher G & A amounts as a full year's cost is incurred for new employees added in 2003. Kinloch signed a 5-year lease for office space concurrent with the Nu-Sky acquisition, which should satisfy office requirements in the immediate future.

During 2003 Kinloch began capitalizing salaries and consulting fees of its geological and geophysical department of $112,000, which will increase in 2004 reflecting a full year of salaries for such personnel.

Overhead recoveries commenced in 2003 as the Company became operator of the majority of its production, whereby fees are charged for marketing partners' share of petroleum and natural gas, charges for administration and operatorship of partners' wells and charges to partners to administer capital expenditures incurred on their behalf, with such recoveries totaling $252,000 for 2003.

Interest Expense

Interest expense for 2003 was $227,000 versus $47,000 for 2002. The larger components of the 2003 expense were $125,000 on Kinloch's credit facilities, $59,000 on flow through share obligations to the federal government and $36,000 on shareholder advances, the latter consisting of interest at 8.75% per annum on a short term bridge financing of $2,400,000 by two officers and directors (or through related corporations) to enable Kinloch to close the Nu-Sky acquisition. These loans together with interest thereon were repaid during the year. Interest expense of $47,000 for 2002 consisted solely of interest payable on flow through share obligations.

Reserves

The following 5 tables summarize significant reserve information, the first 4 of which were extracted from the report prepared by Kinloch's independent engineering consultants and the final table being compiled by management. These reports have been prepared in accordance with National Instrument 51-101. For a full text of information and tables with respect to Kinloch's reserves at December 31, 2003, please visit the SEDAR website at www.sedar.com and view the Company's 2003 Annual Information Form (AIF), or visit Kinloch's website at www.kinlochresources.com

Tables 1 and 2 reflect reserve quantities and values, respectively, using constant prices of $Cdn. 39.57/bbl Edmonton par for oil and Cdn 6.36/mf (AECO-C) for gas, being the average price for December 2003. Tables 3 and 4 reflect reserve quantities and values, respectively, using forecasted prices and costs, although both oil and gas prices are forecasted to drop in 2004 and 2005 before escalation begins.

Table 5 indicates the reconciliation of reserves from December 31, 2002 to December 31, 2003. The negative revisions represent a downgrade of reserves which were substantially booked in the fourth quarter of 2002 and the acquisitions represent the Nu-Sky acquisition evaluated under N151-101 at December 31, 2003 with production for the period from August 1, 2003 to December 31, 2003 added back in order to reflect reserves at the acquisition date.

Table 1

NI 51-101

SUMMARY OF RESERVES AS OF DECEMBER 31, 2003 (Constant Prices & Costs)

	Light & Medium Oil		Heavy Oil		Natural Gas (1)		Natural Gas Liquids	
RESERVES CATEGORY	**Gross (2) (Mbbls)**	**Net (3) (Mbbls)**	**Gross (2) (Mbbls)**	**Net (3) (Mbbls)**	**Gross (2) (MMcf)**	**Net (3) (MMcf)**	**Gross (2) (Mbbls)**	**Net (3) (Mbbls)**
PROVED								
Developed Producing	177.6	158.0	0.0	0.0	2,489	1,912	66.6	45.5
Developed Non-Producing	0.0	0.0	0.0	0.0	1,159	934	1.3	0.8
Undeveloped	338.6	290.0	0.0	0.0	565	442	11.2	8.0
Total Proved	**516.2**	**448.0**	**0.0**	**0.0**	**4,213**	**3,288**	**79.1**	**54.3**
PROBABLE	**152.0**	**132.9**	**0.0**	**0.0**	**3,369**	**2,573**	**53.3**	**35.5**
TOTAL PROVED + PROBABLE	**668.2**	**580.9**	**0.0**	**0.0**	**7,582**	**5,861**	**132.4**	**89.8**

(1) Estimates of Reserves of natural gas include associated and non-associated gas.

(2) "Gross Reserves" are Company's working interest share of remaining reserves before the deduction of royalties.

(3) "Net Reserves" are Company's working interest share of remaining reserves less all Crown, freehold, and overriding royalties and interests owned by others.

Reference: Item 2.1(1) of Form 51-101F1

Table 2

NI 51-101

SUMMARY OF NET PRESENT VALUE OF FUTURE NET REVENUE

AS OF DECEMBER 31, 2003 (Constant Prices & Costs)

RESERVES CATEGORY	Net Present Value (NPV) of Future Net Revenue (FNR)			
	Before Income Taxes - Discounted at (%/yr)		After Income Taxes - Discounted at (%/yr)	
	0 (M$)	10 (M$)	0 (M$)	10 (M$)
PROVED				
Developed Producing	13,922	11,194	13,912	11,153
Developed Non-Producing	4,634	3,307	3,042	2,138
Undeveloped	6,406	3,300	5,397	2,856
Total Proved	**24,962**	**17,801**	**22,351**	**16,147**
PROBABLE	16,436	9,824	10,739	6,370
TOTAL PROVED + PROBABLE	**41,398**	**27,625**	**33,090**	**22,517**

Reference Item 2.1(2) of Form 51-101F1

NPV of FNR includes all resource income: Sale of oil, gas, by-product reserves; Processing of third party reserves; Other income.

Table 3

NI 51-101

SUMMARY OF RESERVES AS OF DECEMBER 31, 2003 (Forecast Prices & Costs)

RESERVES CATEGORY	Light & Medium Oil		Heavy Oil		Natural Gas (1)		Natural Gas Liquids	
	Gross (2) (Mbbls)	Net (3) (Mbbls)	Gross (2) (Mbbls)	Net (3) (Mbbls)	Gross (2) (MMcf)	Net (3) (MMcf)	Gross (2) (Mbbls)	Net (3) (Mbbls)
PROVED								
Developed Producing	161.1	143.2	0.0	0.0	2,474	1,899	66.6	45.7
Developed Non-Producing	0.0	0.0	0.0	0.0	1,159	934	1.3	0.8
Undeveloped	338.6	290.7	0.0	0.0	566	442	11.2	8.0
Total Proved	**499.7**	**433.9**	**0.0**	**0.0**	**4,199**	**3,275**	**79.1**	**54.5**
PROBABLE	**144.5**	**126.4**	**0.0**	**0.0**	**3,374**	**2,568**	**53.9**	**35.7**
TOTAL PROVED + PROBABLE	**644.2**	**560.3**	**0.0**	**0.0**	**7,573**	**5,843**	**133.0**	**90.2**

(1) Estimates of Reserves of natural gas include associated and non-associated gas.

(2) "Gross Reserves" are Company's working interest share of remaining reserves before the deduction of royalties.

(3) "Net Reserves" are Company's working interest share of remaining reserves less all Crown, freehold, and overriding royalties and interests owned by others.

Reference: Item 2.2.(1) of Form 51-101F1

Table 4

NI 51-101

SUMMARY OF NET PRESENT VALUE OF FUTURE NET REVENUE

AS OF DECEMBER 31, 2003 (Forecast Prices & Costs)

	Net Present Value (NPV) of Future Net Revenue (FNR)									
	Before Income Taxes - Discounted at (%/yr)					After Income Taxes - Discounted at (%/yr)				
	0	5	10	15	20	0	5	10	15	20
RESERVES CATEGORY	(M$)	(M$)	(M$)	(M$)	(M$)	(M$)	(M$)	(M$)	(M$)	(M$)
PROVED										
Developed Producing	11,729	10,609	9,742	9,056	8,501	11,712	10,575	9,694	8,998	8,434
Developed Non-Producing	3,779	3,167	2,732	2,404	2,148	2,495	2,076	1,779	1,555	1,381
Undeveloped	3,962	2,647	1,761	1,141	694	4,501	3,197	2,316	1,692	1,237
Total Proved	**19,470**	**16,423**	**14,235**	**12,601**	**11,343**	**18,708**	**15,848**	**13,789**	**12,245**	**11,052**
PROBABLE	13,300	10,111	8,102	6,747	5,782	9,062	6,854	5,497	4,598	3,966
TOTAL PROVED + PROBABLE	**32,770**	**26,534**	**22,337**	**19,348**	**17,125**	**27,770**	**22,702**	**19,286**	**16,843**	**15,018**

Reference Item 2.2 (2) of Form 51-101F1

NPV of FNR includes all resource income: Sale of oil, gas, by-product reserves; Processing of third party reserves; Other income.

Table 5

NI 51-101

RECONCILIATION OF COMPANY RESERVES (1) BY PRINCIPAL PRODUCT TYPE

SUMMARY OF RESERVES AS OF DECEMBER 31, 2003 (Forecast Prices & Costs)

	Light & Medium Oil			Heavy Oil			Natural Gas (2)		
	Company Proved (Mbbls)	Company Probable (Mbbls)	Company Prov+Prob (Mbbls)	Company Proved (Mbbls)	Company Probable (Mbbls)	Company Prov+Prob (Mbbls)	Company Proved (MMcf)	Company Probable (MMcf)	Company Prov+Prob (MMcf)
FACTORS									
Opening Balance (12/31/2002)	47.0	17.0	64.0	0.0	0.0	0.0	855.0	319.0	1174.0
Extensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Improved Recovery	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Technical Revisions	(37.5)	(15.5)	(53.0)	0.0	0.0	0.0	(611.4)	(190.0)	(801.4)
Discoveries	0.0	0.0	0.0	0.0	0.0	0.0	231.0	231.0	462.0
Acquisitions (3)	507.2	143.0	650.0	0.0	0.0	0.0	4436.4	3014.0	7460.4
Dispositions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic Factors	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Production	(17.0)	0.0	(17.0)	0.0	0.0	0.0	(722.0)	0.0	(722.0)
Closing Balance (12/31/2003)	499.7	144.5	644.0	0.0	0.0	0.0	4199.0	3374.0	7573.0

(1) Reserves shown are Company working interest reserves and include all royalty volumes.

(2) Natural gas includes all Associated and Non-Associated gas.

(3) The Nu-Sky Energy Inc. acquisition by Kinloch Resources was effective August 1, 2003. The reserves volumes shown reflect the December 31, 2003 Go-Forward Nu-Sky Reserves plus the Nu-Sky Production Volumes From Aug 1, 2003 forward.

Depletion, Depreciation & Amortization (DD&A)

	2003	2002
DD&A ($000's)	3,422	48
$/boe	23.24	10.43

DD&A increased on a boe basis in the fourth quarter when compared to the third quarter of 2003 by approximately 17% reflecting lower reserve valuations as a result of the NI 51-101 reserve valuation, which was partially offset by a downward revision in the Nu-Sky purchase price in the fourth quarter, largely related to a positive future income tax adjustment with respect to the Nu-Sky acquisition.

The company has prepared a ceiling test calculation as at December 31, 2003 which revealed a potential ceiling test deficiency, substantially related to the Nu-Sky acquisition. Since the ceiling test only takes into account proven reserves and the Company's reserve report indicates significant probable reserves, which could otherwise mitigate the ceiling test deficiency, the Company has used the recent acquisition exemption under the full cost guidelines in effect at December 31, 2003 and accordingly no ceiling test write down was recorded. Had the ceiling test write down been recognized at December 31, 2003, DD&A would have increased by $10,299,000 and the future tax recovery would have increased by $3,483,000, resulting in an increase of the net loss of $6,816,000.

Notwithstanding the above, a new accounting guideline (ACG-16) regarding full cost accounting for oil and gas companies became effective for fiscal years commencing on or after January 1, 2004. The new guideline limits the carrying value of oil and natural gas to their fair value, which is ascertained from the estimated future pre-tax cash flows from proved and probable reserves using future price forecasts and costs, discounted at a risk free basis. This differs from the current ceiling test that uses undiscounted after tax cash flows and constant prices and costs, less future general and administrative expenses and financing costs. Under the new method, a ceiling test write down will be recorded in January, 2004, largely as a result of using discounted future cash flows and forecasted future commodity prices which are initially lower than what the constant price model for December 2003 indicated. The adjustment will be recorded through the balance sheet pursuant to a retroactive change in accounting policy, and accordingly will not affect Kinloch's 2004 earnings, other than a reduction in future DD&A. The change will result in a reduction of property and equipment of $7,800,000, a reduction in future income taxes of $2,767,000 and a charge to the Company's deficit of $5,033,000.

Site Restoration and Abandonment

The site restoration and abandonment provision was $138,000 for 2003 compared with $2,000 for 2002. Since this provision is done on an accrual basis based on the depletion and depreciation rate, the increase is linked to the increase in the DD&A provision.

A new accounting standard for asset retirement obligations came into effect for all fiscal years beginning on or after January 1, 2004. The new standard requires recognition of a liability for the future retirement obligations associated with property, plant and equipment. These obligations are initially measured at fair value, which is the discounted future value of the liability. This fair value is capitalized as part of the cost of the related asset and amortized to expense over its useful life. The liability accretes until the date of expected settlement of the retirement obligations. The impact of the effect of this new standard on the financial statements is as follows: increase property, plant and equipment and the site restoration and abandonment liability on the balance sheet, but is not expected to have a material impact on earnings. Kinloch will make this change retroactively in January, 2004 with adjustment to the prior years' accounts.

A new accounting policy effective in January, 2004 with respect to flow through shares requires the tax effect be recognized as a reduction of share capital on the date of renunciation, whereby Kinloch previously recognized same when the monies were expended. Accordingly, in January, 2004 Kinloch will reduce share capital by $355,000 pursuant to the $1,000,000 of flow through shares renounced on December 31, 2003.

Income Taxes

Kinloch recorded a future income tax recovery of $452,000 in 2003 based on its pretax loss of $1,139,000. In 2002 the future tax recovery is $540,000 was predominately a reflection of recognizing previously unrecognized tax losses as a result of accounting for flow through share renunciations in 2002. As at December 31, 2003 the benefit of all tax

losses had been recorded in conjunction with the Nu-Sky acquisition, except for capital losses of $433,000 which are restricted against future capital gains.

The Company recorded current capital taxes of $53,000 for 2003 representing the federal large corporations tax. Based on Kinloch's December 31, 2003 balance sheet, there should be no capital taxes for 2004, as the threshold for determining when a company is a large corporation has been increased.

Management has reviewed Kinloch's tax horizon, and given forecasted production, commodity prices and capital expenditures, the Company should not have to pay cash taxes until the latter part of 2005, with the possibility of a total deferral to 2006, depending on the amount of capital spent in 2004 and 2005.

Capital Expenditures

Excluding the Nu-Sky acquisition, Kinloch incurred capital expenditures of $4,282,000 in 2003 versus $1,653,000 for the prior year. Total consideration for the Nu-Sky acquisition, which was funded by approximately 59% cash and 41% by the issuance of Kinloch shares at an attributed price of $1.00 per share, was $22,351,000.

During 2003, Kinloch drilled 9 gross (6.37) net wells, resulting in 2 gross oil wells (2.0 net), 2 gross (1.35 net) gas wells and 5 gross (3.02 net) dry holes for an overall success ratio of 52.6% on a net well basis.

The following is a breakdown of the 2003 and 2002 capital expenditures:

	2003	2002
Land	$356,000	$175,000
Seismic	251,000	117,000
Capitalized geological and geophysical overhead	112,000	-
Drilling and completions	2,661,000	1,308,000
Production equipment and tie-ins	889,000	44,000
Office equipment	13,000	9,000
Total	$4,282,000	$1,653,000

Liquidity and Capital Resources

Concurrent with the Nu-Sky acquisition, Kinloch negotiated a revolving demand loan of $13,000,000 with its banker, with the authorized amount reducing by $750,000 each quarter as a result of depletion. As at December 31, 2003, the authorized credit facility was $11,500,000 and the amount drawn at December 31, 2003 was $3,141,000. It is expected that the amount drawn will increase in 2004 as the company pays down its working capital deficiency at December 31, 2003, combined with 2004 capital expenditures.

Kinloch used equity financing as a major component of its growth in 2003, firstly as partial consideration of the Nu-Sky acquisition, whereby 9.1 million shares were issued for $9.1 million and in September, 6.5 million shares and .5 million flow through shares were issued for net proceeds of $10.27 million. Subject to market conditions, it is anticipated that equity financing will continue as a major vehicle for future growth.

Critical Accounting Estimates

Timely release of financial information sometimes necessitates the use of estimates when transactions and other factors which may affect the current accounting period cannot be finalized until future periods. The most significant estimate for oil and gas companies is determining reserves including the mix between proven and probable. These estimates affect depletion, depreciation and amortization, site restoration and the ceiling test which ultimately affects the carrying value of the Company's oil and gas properties. Other critical estimates involve the accruals for revenue, expenses and capital expenditures with such estimates becoming more significant as accelerated reporting requirements will be required in 2004. Where necessary, such estimates are based on informed judgments made by management.

Other Matters- Continuous Disclosure

The Company wishes to bring to the attention of readers that particulars of related party transactions, including business purpose have been disclosed in Note 6 to the financial statements, and Notes 9 and 10 disclose the significant commitments and contractual obligations of the Company. Management is not aware of my off-balance sheet arrangements as at December 31, 2003 or arising subsequently.

Business Risks

Commodity prices may become quite volatile, reflecting the current tight supply and demand fundamentals for North America natural gas and world crude. Political events around the world, which are impossible to predict, will continue to influence both oil and natural gas prices. Higher commodity prices often lead to higher levels of industry activity, which in turn lead to higher costs for land, reserves and services. These higher costs influence the investment returns received on the Company's capital expenditures. In addition to volatile commodity prices, the Company's results are influenced by currency exchange rates between the Canadian and U.S. dollar. For a more detailed outline please refer to the "Risk Factors" in the Company's 2003 Annual Information Form available on Kinloch's website at www.kinlochresources.com or at www.sedar.com.

Outlook

Strong commodity prices continued beyond 2003 and indications point towards some level of price sustainability in the near term. The assets acquired in the Nu-Sky acquisition are characterized as primarily gas oriented with steep declines. This translates into unsustainable production volumes unless additions can be achieved. During the first quarter of 2004, two oil wells, which were drilled and completed in the third quarter of 2003, and the first quarter of 2004 have began producing and a gas well was tied in, which will partially mitigate some of the declines. Three standing gas wells and one standing oil well are expected to be brought on production in the second quarter and a gas well drilled in last quarter of 2003 will commence production with the expansion of a gas plant scheduled for the last half of 2004. The Buick Creek non-operated gas well, which is forecasted to cease producing sometime in 2004, but presently represents about 15% - 20% of Kinloch's daily production was shut in due to mechanical problems in mid March, 2004. The company is hopeful that the problems will be rectified after spring breakup.

Kinloch looks forward to its next drilling program, which is scheduled to commence after spring breakup, on the Company's existing lands, some of which were recently acquired, as well as opportunities arising from its recently announced access to 500 square kilometers of 3-D seismic data in Central Alberta.

MANAGEMENT'S REPORT

These financial statements are the responsibility of the Management of Kinloch Resources Inc. They have been prepared with Canadian generally accepted accounting principles using Management's best estimates and judgments, where appropriate.

Management is responsible for the reliability and integrity of the financial statements, notes to the financial statements and other financial information contained in this report. Estimates are sometimes necessary in the preparation of these statements because a precise determination of some assets and liabilities depends on future events. Management has based these estimates on careful judgments and believes they are properly reflected in the accompanying financial statements. Management is also responsible for maintaining a system of internal controls designed to provide reasonable assurance that assets are safeguarded and that accounting systems provide timely, accurate and reliable financial information.

The Board of Directors of Kinloch Resources Inc. is responsible for ensuring that Management fulfills its responsibilities for financial reporting and internal controls through its Audit Committee, which is comprised of independent Directors and meets at least every quarter. The Board also meets with Management to ensure that Management's responsibilities are fulfilled, to review financial statements and to recommend approval of the financial statements. The Board of Directors has approved the information contained in the financial statements. An independent auditor, PriceWaterhouseCoopers LLP, has audited the financial statements of Kinloch Resources Inc. in accordance with Canadian generally accepted auditing standards and has provided an independent opinion.

Paul W. M. Read
Chairman, President and
Chief Executive Officer

James B. Howe
Vice President Finance
and Chief Financial Officer

Auditors' Report

To the Shareholders of
Kinloch Resources Inc.

We have audited the balance sheets of **Kinloch Resources Inc.** as at December 31, 2003 and 2002 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "PricewaterhouseCoopers LLP"

Chartered Accountants

Calgary, Alberta
March 31, 2004

Balance Sheets
As at December 31, 2003 and 2002

	2003 $	2002 $
Assets		
Current assets		
Cash and term deposits	-	3,839,679
Accounts receivable	3,134,470	256,529
Prepaid expenses	201,626	4,380
	3,336,096	4,100,588
Property, plant and equipment (note 4)	36,855,791	1,949,367
	40,191,887	6,049,955
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	6,460,773	965,716
Income taxes payable	58,902	-
Bank indebtedness (note 5)	3,140,713	-
	9,660,388	965,716
Future site restoration	429,091	15,357
Future tax liability	6,560,808	-
	16,650,287	981,073
Shareholders' Equity		
Share capital (note 7)	30,175,729	10,962,473
Deficit	(6,634,129)	(5,893,591)
	23,541,600	5,068,882
	40,191,887	6,049,955

Commitments (note 9)

See accompanying notes to the financial statements

Approved by the Board of Directors

_______________ Director _______________ Director

Statements of Operations and Deficit

For the years ended December 31, 2003 and 2002

	2003 $	2002 $
Revenue		
Production revenue	5,678,099	130,451
Royalties, net of ARTC	(1,010,033)	(19,067)
Other revenue	77,669	76,614
	4,745,735	187,998
Expenses		
Operating	1,502,049	37,589
General and administrative	575,639	204,703
Interest	227,252	47,310
Site restoration and abandonment	137,900	1,800
Depletion, depreciation and amortization	3,442,161	47,601
	5,885,001	339,003
Loss before income taxes	(1,139,266)	(151,005)
Income tax (recovery) expense		
Future income taxes (note 8)	(452,000)	(540,000)
Capital taxes	53,272	-
	(398,728)	(540,000)
Net (loss) earnings for the year	(740,538)	388,995
Deficit – Beginning of year	(5,893,591)	(6,282,586)
Deficit – End of year	(6,634,129)	(5,893,591)
(Loss) earnings per share		
Basic	(0.06)	0.11
Diluted	(0.06)	0.10
Weighted average number of shares outstanding		
Basic	12,714,380	3,582,812
Diluted	12,797,491	3,793,298

See accompanying notes to the financial statements

Statements of Cash Flows
For the years ended December 31, 2003 and 2002

	2003 $	2002 $
Cash provided by (used in)		
Operating activities		
Net (loss) earnings for the year	(740,538)	388,995
Items not requiring cash from operations		
Depreciation, depletion and amortization	3,442,161	47,601
Site restoration and abandonment provision	137,900	1,800
Future income tax recovery	(452,000)	(540,000)
	2,387,523	(101,604)
Net change in non-cash working capital items	(4,049,445)	(174,998)
	(1,661,922)	(276,602)
Investing activities		
Purchase of property, plant and equipment	(4,282,090)	(1,652,900)
Abandonment expenditures	(14,270)	(8,358)
Acquisition of Nu-Sky Energy Inc. (net of cash of $7,870)	(13,243,235)	-
Net change in non-cash working capital items	1,627,065	890,754
	(15,912,530)	(770,504)
Financing activities		
Issuance of common shares, net of costs	10,594,060	2,111,120
Issuance of preferred shares, net of costs	-	(1,320)
Increase in bank indebtedness	3,140,713	-
	13,734,773	2,109,800
(Decrease) increase in cash	(3,839,679)	1,062,694
Cash and term deposits – Beginning of year	3,839,679	2,776,985
Cash and term deposits – End of year	-	3,839,679
Supplemental information		
Interest income received	61,228	70,511
Interest paid	208,638	-

See accompanying notes to the financial statements

Notes to Financial Statements

December 31, 2003 and 2002

1 Company activities

The Company's principal business activity is exploration for and exploitation of oil and natural gas reserves in Western Canada.

2 Significant accounting policies

The Company prepares its financial statements following generally accepted accounting principles in Canada.

Cash and term deposits

Cash is comprised of cash balances and investments in commercial paper with a duration of three months or less.

Petroleum and natural gas properties

a) Capitalized costs

The Company follows the full cost method of accounting, whereby all costs incurred in exploring for and developing oil and gas reserves are capitalized. Such expenditures include land acquisition costs, geological and geophysical costs, carrying charges for unproved properties, costs of drilling both productive and unproductive wells, gathering and production facilities and general and administrative costs directly related to exploration and development activities. Capitalized costs are accumulated in a single cost center. Gains and losses are not recognized upon disposition of oil and gas properties unless such a disposition would significantly alter the rate of depletion.

b) Depletion and depreciation

Capitalized costs of properties having proved reserves, including a provision for future costs to develop such reserves, are amortized through depletion and depreciation charges using the unit-of-production method based on estimated crude oil and natural gas reserves, as determined by independent reservoir engineers. For purposes of these calculations, production of crude oil, natural gas liquids, natural gas, and proved reserves before royalties are converted to a common unit-of-measure on the basis of their approximate relative energy content. Costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment occurs. Other fixed assets are depreciated on a declining balance basis at a rate of 20% per annum.

c) Ceiling test

The net carrying value of the Company's oil and gas properties and production equipment in cost centers is limited to an estimated recoverable amount. This amount is calculated as the aggregate future net revenues from proved reserves plus the cost of unproved properties, net of impairment allowances. Future net revenues are calculated using prices in effect at the ceiling test date without escalation or discounting.

The net carrying value of all cost centers, less related accumulated provisions for future site restoration costs and future income taxes, is further limited to the total estimated recoverable amount of all cost centers, less future general and administrative costs, financing costs and income taxes.

d) Future site restoration

Future estimated site restoration costs for property, plant and equipment, net of expected recoveries, are accrued and charged against income over the life of the estimated proved crude oil and natural gas reserves using the unit-of-production method. Site restoration expenditures incurred are charged to the accumulated provision for future site restoration.

Joint interest operations
Certain of the Company's exploration and development activities are conducted jointly with other parties and, accordingly, the accounts reflect only the Company's proportionate interest in such activities.

Income taxes
The Company follows the future income tax method of tax allocation accounting. Under this methodology, recognition of a future tax liability or asset is dependent on the expected tax outflow or benefit to be derived from differences between the carrying value and tax basis of assets and liabilities on settlement.

Flow-through shares
Expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. Share capital is reduced by the estimated cost of the renounced tax deductions when the expenditures are incurred.

Stock options
The consideration paid by the employee in order to exercise stock options is credited to share capital. No compensation expense is recognized when stock options are issued to employees.

Revenue recognition
Revenues from petroleum and natural gas sales are recognized when title passes from the Company to its customer.

Measurement uncertainty
Management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from these estimates.

Earnings per share
The Company uses the treasury stock method of calculating per share amounts whereby any proceeds from the exercise of stock options or other dilutive instruments are assumed to be used to purchase common shares at the average market price during the period.

3 Acquisition of Nu-Sky Energy Inc.

On July 31, 2003, Kinloch acquired, through a Plan of Arrangement, all of the issued and outstanding shares of Nu-Sky Energy Inc. ("Nu-Sky"), a public company engaged in the exploration for and production of oil and gas in Western Canada. The transaction was accounted for by the purchase method, based on fair market value as follows:

Net assets acquired	$
Capital assets	34,066,495
Working capital deficiency	(4,893,283)
Future site restoration	(290,104)
Future income taxes	(6,531,929)
	22,351,179
Consideration given	
Cash	13,251,103
Non-cash issue – 9,100,076 Kinloch shares @ $1.00 per share	9,100,076
	22,351,179

Nu-Sky was wound up into Kinloch on August 1, 2003.

4 Property, plant and equipment

			2003
	Cost	Accumulated depletion and depreciation	Net book value
	$	$	$
Oil and natural gas properties	40,227,523	3,485,380	36,742,143
Other assets	138,510	24,862	113,648
	40,366,033	3,510,242	36,855,791

			2002
	Cost	Accumulated depletion and depreciation	Net book value
	$	$	$
Oil and natural gas properties	1,981,743	58,780	1,922,963
Other assets	35,705	9,301	26,404
	2,017,448	68,081	1,949,367

Costs of $2,693,000 (2002 – $107,698) relating to unproved properties and seismic thereon have been excluded from the Company's depletable base.

At December 31, 2003, the estimated future site abandonment and restoration costs to be accrued over the remaining life of proven reserves were $1,639,659 (2002 – $63,794).

General and administrative expenses relating to exploration activities of $111,501 were capitalized in 2003 (2002 – $nil).

The ceiling test calculation at December 31, 2003 resulted in a ceiling test deficiency, largely as a result of the assets acquired in the Nu-Sky acquisition. Since the expected value of probable reserves exceeds the potential impairment charge, the Company uses the recent acquisition exemption under the existing full cost accounting guideline and no impairment charge is recorded. Had a ceiling test write down been recognized at December 31, 2003, depletion, depreciation and amortization would have increased by $10,299,000 and the

future income tax recovery would have increased by $3,483,000, resulting in an increase in the net loss of $6,816,000.

5 Bank indebtedness

The credit facility is a revolving demand loan for a maximum authorized amount of $11,500,000, which reduces by $750,000 at the end of each fiscal quarter. The loan bears interest at the bank's prime lending rate plus 0.25% and is secured by a $50,000,000 demand debenture and a first floating charge over all assets of the Company. The Company has the ability to substitute all or a portion of the drawn down amount by utilizing bankers' acceptances at current rates plus 1.25% per annum stamping fee. The credit facility revolves until May 31, 2004, at which time it may be renewed, or, at the option of the bank or the Company, it may be converted to a term facility with a term not exceeding 5 years, the term and required principal payments to be determined by the bank at the time of conversion.

6 Related party transactions

During 2003 and in conjunction with the hiring of two officers of the Company, private placements for 290,000 common shares were completed for aggregate consideration of $250,400. An interest free loan in the amount of $149,600 was made by the Company to one of the officers and such amount was repaid in full prior to December 15, 2003.

In conjunction with the Nu-Sky acquisition (note 3) and as a condition of the bank financing (note 5), two senior officers and directors, either directly or indirectly through related corporations, advanced to Kinloch $2,400,000 in aggregate as a bridge loan, bearing interest at 8.75% per annum. These loans were repaid during the year , along with interest totalling $35,671.

7 Capital stock

Authorized

Unlimited number of common shares without nominal or par value
Unlimited number of non-voting common shares without nominal or par value
Unlimited number of preferred shares without nominal or par value

Issued

	Number of shares	Amount $
Common shares		
Balance – December 31, 2001	3,341,433	7,696,173
Issued for cash pursuant to a private placement	93,750	75,000
Issued of flow-through shares for cash pursuant to a private placement	1,971,400	2,168,540
Issued for cash pursuant to exercise of stock options	10,000	2,600
Share issuance expenses, net of tax effect of $57,032	-	(77,988)
Tax effect of flow-through funds expended during the year	-	(597,586)
Balance – December 31, 2002	5,416,583	9,266,739
Issued for cash pursuant to employee Private Placements (note 6)	290,000	250,400
Issued for cash pursuant to exercise of stock options	295,000	76,700
Conversion of preferred shares – Series A	3,400,000	1,695,734
Issued pursuant to Nu-Sky acquisition (note 3)	9,100,076	9,100,076
Issued for cash pursuant to Private Placement	6,500,000	10,075,000
Issued for cash pursuant to flow-through private placement	500,000	1,000,000
Tax effect of flow-through funds expended during the year	-	(760,880)
Share issuance expenses, net of tax effect of $280,000	-	(528,040)

	Number of shares	Amount $
Balance – December 31, 2003	25,501,659	30,175,729
Preferred shares – Series 'A'		
Balance – December 31, 2002	3,400,000	1,695,734
Conversion to Common shares	(3,400,000)	(1,695,734)
Balance – December 31, 2003	-	-
Share capital balance as at December 31, 2003	25,501,659	30,175,729

The preferred shares, Series 'A' are non-voting and entitled to dividends only in the event that dividends are declared on the Common shares and in an amount equal to the dividend paid per Common share. The shares were only redeemable upon the successful completion of a takeover bid for the Company at the greater of $0.50 per share and the offer price per Common share under the takeover. Pursuant to the Plan of Arrangement in conjunction with the Nu-Sky acquisition, the preferred shares were converted to Common shares on a 1 for 1 basis.

As at December 31, 2003, the Company has $1,000,000 of flow-through expenditures to be incurred during 2004.

As at December 31, 2003, 150,000 (2002 – 450,000) Common shares were subject to the TSX Exchange escrow provisions.

The Company has established a Stock Option Plan for the benefit of its directors, employees and certain consultants. Stock options granted to directors and others are subject to a one-year and three-year vesting periods respectively.

A summary of the outstanding stock options as of December 31, 2003 and 2002 and changes during the years then ended follows:

	2003		2002	
Fixed Options	**Shares**	**Weighted-Average Exercise Price**	**Shares**	**Weighted-Average Exercise Price**
Outstanding – Beginning of year	480,000	0.37	410,000	0.26
Granted	1,365,000	1.03	100,000	0.80
Exercised	(295,000)	0.26	(10,000)	0.26
Cancelled	(25,000)	0.26	(20,000)	0.26
Outstanding – End of year	1,525,000	0.99	480,000	0.37
Exercisable – End of year	243,333	0.79	282,667	0.26

Options outstanding			Options exercisable	
Weighted average exercise price	Number outstanding	Weighted average remaining life	Weighted-average exercise price	Number exercisable
$0.99	1,525,000	4.40 years	$0.79	243,333

The Company accounts for its stock based compensation plan using the intrinsic value method whereby no compensation costs are recognized in the financial statements for share options granted to employees, officers and directors.

Stock-based compensation costs

If the fair value method had been used based on the Black-Scholes model, whereby stock-based compensation costs related to employees, officers and directors are recognized as an expense in the financial statements for options granted subsequent to January 1, 2002, the Company's net income and net income per share would approximate the following pro forma amounts:

	2003 $	2002 $
Stock-based compensation costs	91,583	5,800
Net (loss) earnings attributable to common shareholders		
As reported	(740,538)	388,995
Pro forma	(832,121)	383,195
Net (loss) earnings per common share attributable to common shareholders		
As reported	(0.06)	0.11
Pro forma	(0.07)	0.11
Fair value of options granted per common share	0.35	0.64
Risk-free interest rate	3.64%	3.64%
Expected life (years)	3	3
Expected volatility	45%	133%
Expected dividend yield	0%	0%

8 Income taxes

The total provision for income taxes differs from the expected amount applying the combined Federal and Provincial tax rate of 40.75% (2002 – 42.2%) to earnings before income taxes. The difference results in the following items:

	2003 $	2002 $
Loss before income taxes	(1,139,266)	(151,005)
Expected tax recovery	(464,194)	(63,724)
Crown charges, net of ARTC	256,389	8,601
Resource allowance	(272,994)	17,784
Effect of change in tax rates	261,348	7,980
Other	2,451	(5,942)
Recognition of previously unrecognized tax benefits	(235,000)	(504,699)
	(452,000)	(540,000)

The Company has non-capital losses available to reduce future taxable income at December 31, 2003 of $4,876,026, which expire as follows:

	$
2004	2,108,505
2005	623,317
2006	1,903,706
2007	117,980
2009	122,518
	4,876,026

Based on current information, the Company expects to utilize these losses prior to their expiry dates.

Future income taxes consist of the following temporary differences:

	$
Property, plant and equipment	8,978,952
Share issuance expenses	(381,000)
Non-capital losses	(1,730,000)
Site restoration and abandonment	(152,000)
	6,715,952
Valuation allowance	(155,144)
	6,560,808

In summary, the Company has the following amounts which may be available for deduction in determining taxable income of future years:

	$
Non-capital losses	4,876,026
Capital losses	433,823
Canadian development expense	2,121,168
Canadian exploration expense	614,841
Canadian oil and gas property expense	2,373,955
Undepreciated capital cost	6,270,593
Share issue expenses	1,074,255
	17,764,661

9 Commitments

The Company has executed a Lease Agreement for the office space it currently occupies. The lease commenced on October 1, 2003 and will expire on September 30, 2008. Based on current operating costs, the future lease commitments are estimated as follows:

	$
2004	129,904
2005	131,311
2006	136,937
2007	141,156
2008	104,320
	643,628

10 Financial Instruments

The Company's financial instruments as at December 31, 2003 are comprised of cash, accounts receivable, and all current liabilities. The carrying amounts of these financial instruments approximate their estimated market values.

The Company is exposed to credit risk from financial instruments to the extent of non-performance by third parties. A substantial portion of the Company's accounts receivable and accounts payable are with customers and joint venture partners in the petroleum and natural gas industry and are subject to normal credit risks.

On November 1, 2003, the Company had entered into a costless collar arrangement for the sale of 2,000 gigajoules per day of gas to March 31, 2004, with a floor price of $6.00/GJ and a ceiling price of $9.85/GJ. At December 31, 2003 and using December 31, 2003 forward commodity prices, the cost to settle the contract would be immaterial.

Corporate Information

Board of Directors & Officers

Paul W.M. Read, P.Eng.
Chairman, President and Chief Executive Officer

James B. Howe, C.A.
Vice President, Finance, Chief Financial Officer, and Director

Robin B. Dow, MBA [1,2]
Director

James M. Franklin, P.HD [1,2]
Director

Keith E. MacDonald, C.A. [1,2]
Director

Stephen C. Farner, B.Sc. (Geology and Geophysics)
Vice President, Exploration

Curtis W. Labelle, P.Eng.
Vice President, Operations

Ron A. Parisien, B.Comm.
Controller

Fiona M.D. Read, P.Eng.
Director Corporate Development

[1] *Audit Committee*
[2] *Reserves Committee*

Transfer Agent
Valiant Trust Company

Bankers
The Bank of Nova Scotia

Auditors
PricewaterhouseCoopers LLP

Legal Counsel
Robinson Stewart

Stock Exchange
Toronto Stock Exchange

Trading Symbol: KTE

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